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SUBJECT: DUTCH 2006 BUDGET: REFORM, GROWTH, AND UNCERTAINTY

REF: 04 THE HAGUE 2569

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1. (SBU) SUMMARY. With early indications of a long-awaited economic recovery as a backdrop, the Netherlands' center-right governing coalition presented a draft 2006 budget that seeks to ensure continued economic growth through additional structural reforms of the country's welfare system and measures aimed at offsetting the effect of such changes on individual incomes. Some policy observers have raised concerns that these measures could result in greater uncertainty over household incomes and actually hurt private consumption and consumer confidence. The GONL's success in implementing such policies could be hindered by its own lack of popularity among the general population, which holds the government responsible for the country's recent economic woes.

2. (SBU) Other supply-side measures in the 2006 budget are intended to improve the business climate in the Netherlands through cuts in the corporate tax rate and a reduced regulatory burden, especially for small- and medium-sized enterprises. Increases in spending on defense and counterterrorism efforts point to a larger emphasis on national security concerns. END SUMMARY

2006 BUDGET - LOOKING TOWARD RECOVERY

3. (U) Following a strong performance in the late 1990s, the Dutch economy has struggled in recent years, plagued by relatively high costs and weak domestic demand. (On average, GDP growth for the years 1996-2000 was 3.7 percent, while it is only expected to reach an average of 0.7 percent for the years 2001-2005.) GDP growth recovered in 2004 to 1.7 percent, largely due to a turnaround in net exports, an increased profitability of Dutch companies, and a corporate investment growth rate of 3.3 percent. Inflation fell from 2.1 percent in 2003 to 1.2 percent in 2004, despite higher oil prices. However, private consumption did not increase in 2004, partly because of a persistently high unemployment rate of 6.4 percent. Productivity growth also remained negligible in comparison with the U.S. and certain other European country competitors.

4. (U) With this as a backdrop, Dutch Finance Minister Gerrit Zalm presented to parliament on September 20 a draft 2006 national budget aimed at ensuring continued economic growth through the introduction of further structural reforms to the country's welfare system, measures intended to boost private consumption, and additional supply-side reforms designed to improve the Dutch business climate. The draft 2006 budget assumes a projected 2.5 percent GDP growth in 2006 (up from a forecasted 0.5 percent in 2005 and above the eurozone average of 1.8 percent); a further drop in inflation to 1 percent (down from an anticipated 1.5 percent in 2005); unemployment decreasing slightly to 6.25 percent (from an estimated 6.75 percent in 2005); estimated revenues totaling 137.4 billion euros (USD 166.4 billion); and government expenditures increasing to 146.7 billion euros (USD 177.7 billion). With a resulting budget deficit of 9.3 billion euros (USD 11.3 billion), or 1.8 percent of GDP, the GONL will remain below the 3 percent budget deficit threshold mandated in the EU Stability and Growth Pact (SGP). (A detailed analysis of the Dutch fiscal situation is contained in the "Selected Issues" paper accompanying the recent IMF Article IV review of the Dutch economy, available at www.imf.org.)

THE MAN ON THE STREET

15. (U) Structural reform aspects of the draft budget build on measures taken last year (see reftel), including the introduction of tougher disability benefit criteria and a compulsory healthcare insurance system on January 1, 2006 (with higher premiums and greater care provider choices), the elimination of a distinction between public and private health insurance programs, and the discontinuation of tax incentives that made early retirement and pre-pension schemes financially attractive for employees under the age of 65. Under the proposed new disability criteria, eligibility for benefits would be limited to individuals that are fully incapacitated or unable to work. However, the benefits to individuals qualifying for such benefits would increase from 70-75 percent of the individual's previous earned income. (Those partly incapacitated would receive partial benefits and be required to work part-time.) An estimated one million people (out of a work force of 7.6 million) currently collect disability benefits in the Netherlands.

16. (U) Other measures are aimed at compensating Dutch citizens for the anticipated higher insurance premiums noted above, including some 2 billion euros in tax cuts and 0.5 billion in increased public spending. These measures include income-based care benefits, a general tax credit, the elimination of occupancy-related property taxes, reductions in employees' unemployment insurance contributions, the elimination of school fees for certain groups of secondary students, and increased spending on education and child care benefits. Meanwhile, the Dutch Labor Party (PvdA) has expressed concern that the proposed measures will primarily benefit high-income brackets.

IMPROVING THE BUSINESS CLIMATE -----

17. (U) Supply-side reform measures in the budget are intended to improve the business climate in the Netherlands through cuts in the corporate tax rate and further reductions in regulatory/administrative costs, especially for small- and medium-sized enterprises. Under the plan, the corporate tax rate will fall to 29.6 percent in 2006 from 31.5 percent this year and 34.5 percent in 2004. Additional cuts are planned for 2007. (However, the overall corporate tax burden is not expected to change due to offsetting fiscal measures and a widening of the tax base.) New measures aimed at reducing regulatory/administrative costs include uniform wage definitions and simplified rules governing work conditions.

BIGGER ROLE FOR DEFENSE AT NATIONAL LEVEL -----

18. (U) Under the draft budget, Ministry of Defense (MOD) spending will increase by 95 million to 7.2 billion euros (USD 8.7 billion) in 2006, or about 1.7 percent of GDP. (This increase will maintain the MOD's purchasing power in real terms, following a decade of steady declines in the overall MOD budget.) MOD personnel are expected to become more involved in national security, with an anticipated 3000 military personnel playing a permanent role within the Netherlands' national borders under civil authority. The MOD also plans to draw up new plans for protecting the country's airspace and harbors, including joint exercises with the police, army, and other national security services.

19. (U) Given shortages in the Dutch labor market, the MOD plans to turn to other NATO countries to recruit several hundred specialists for technical support tasks, especially within its air force. There are plans for the creation of a fourth armored infantry battalion and an expanded intelligence battalion (Istar). A pool of 60 special forces will be established to contribute to disarmament and demobilization programs in crisis areas. Defense Minister Kamp has also announced plans to purchase two C130 Hercules transport aircraft and five new Chinook transport helicopters from the U.S.

TARGETING TERRORISM -----

110. (U) The draft budget has earmarked an additional 37 million euros (USD 45 million) for counterterrorism efforts in 2006, with another 40 million euros (USD 48 million) possible in 2007. The funds will largely be spent on increased staffing for the National Counterterrorism Coordinator's Office (NCTb) and the National Prosecutor's office, increased efforts to combat financial crime, and additional resources related to wiretapping. Under the proposed budget plan, the Ministry of Justice notes recent proposals giving police more power to arrest and search persons suspected of preparing terrorist attacks, expanding opportunities for using intelligence information in courts, introducing a new generation of biometric passports and identification cards, expanding the national alert system, conducting large-scale terror exercises more frequently,

enhancing cooperation between the Interior and Defense Ministries, and strengthening cooperation among the NCTb, national security services, the National Prosecutor's office, and immigration services.

COMMENT - REFORM VERSUS UNCERTAINTY

11. (U) Since taking office two years ago, Prime Minister Balkenende's coalition government (VVD, CDA, and D66) has faced much criticism over its efforts to put the Netherlands' economy back on the road to recovery. The Council of State, the highest advisory body and administrative court in the Netherlands, has publicly questioned the logic of supporting increased spending and a budget deficit during the initial stages of an economic recovery. Meanwhile, the parliament's Council of Economic Advisors and the Scientific Council for Government Policy (two quasi-independent advisory bodies) have raised concerns that measures proposed to boost private consumption and consumer confidence are unlikely to compensate for the uncertainty over household incomes that could result from changes and cuts to the Dutch welfare system.

12. (SBU) In her annual speech at the opening of parliament and the presentation of the federal budget on September 20, Queen Beatrix summarized well the GONL's budget and policy goals for 2006: "A safer Netherlands; more people at work; less regulations and more quality of public services; and more mutual respect in our society." However, the greatest obstacle facing the Balkenende government in pursuing these policies may prove to be its own lack of popularity. Recent polling in the country indicates that as many as two-thirds of the population believe that government policies have not helped to improve the economy and more that half believe such policies have had a negative effect.

BLAKEMAN